DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 98-0120 RST
Sales/Use Taxes
For Tax Period: 1995

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. Sales/Use Tax — Equipment and Materials Used or Consumed in Production

Authority: IC 6-2.5-5-3; IC 6-2.5-5-5.1
45 IAC 2.2-5-8(h); 45 IAC 2.2-5-12(f)

Taxpayer protests the assessment of use tax on its purchase of supplies and equipment used or consumed in the manufacturing process.

II. Sales/Use Tax — Manufacturing Equipment Used in Clinical Trials and Testing

Authority: IC 6-2.5-5-3
45 IAC 2.2-5-12(h)
Indianapolis Fruit v. Indiana Department of State Revenue, 691 N.E.2d 1379,1383 (Ind.Tax 1998);
General Motors v. Indiana Department of State Revenue, 578 N.E.2d 399 (Ind.Tax 1991)

Taxpayer protests the assessment of use tax on equipment used in manufacturing products for clinical trials and process testing.

III. Sales/Use Tax — Computer Software

Authority: IC 6-2.5-4-10(a)
45 IAC 2.2-4-2
Sales Tax Information Bulletin #8

Taxpayer protests the assessment of use tax on its purchase of computer software and its purchase of software licensing agreements.

IV. Sales/Use Tax — Protective Clothing, Safety Supplies, and Equipment Cleanser

Authority: IC 6-2.5-5-3
45 IAC 2.2-5-8; 45 IAC 2.2-5-12

Taxpayer protests the assessment of use tax on its purchase of protective clothing, safety supplies, and equipment cleanser.

V. Sales/Use Tax — Packaging Equipment and Supplies

Authority: IC 6-2.5-5-3
45 IAC 2.2-5-8(d)(1)
Indiana Department of State Revenue v. Cave Stone, Inc., 457 N.E.2d 520 (Ind. 1983)

Taxpayer protests the inclusion, in the sample calculated by Audit, of packaging supplies and equipment used in packaging pharmaceutical products.

STATEMENT OF FACTS

Taxpayer manufactures pharmaceutical products. Additionally, taxpayer engages in a variety of ancillary activities – from research and development to marketing and sales. For tax year 1995, Audit assessed use tax on a variety of taxpayer's items. Taxpayer has protested these assessments.

I. Sales/Use Tax — Equipment and Materials Used or Consumed in Production

DISCUSSION

Taxpayer protests the assessment of use tax on its purchase of supplies and equipment used and consumed in the manufacturing process.

Audit assessed use tax on taxpayer's bar coder and drum wash. According to taxpayer, the bar coder was used in quality control testing conducted during the manufacturing process. The drum wash was used in the manufacture of a particular product in a self-contained clean room.

Taxpayer informs the Department that its bar coder plays an essential role in the manufacturing process. Specifically, the bar coder is necessary to enable taxpayer to perform product quality control testing. Taxpayer cites one of the industrial exemptions in support of its position. Manufacturing machinery, tools, and equipment are exempt from Indiana sales and use tax under the provisions of IC 6-2.5-5-3(b), which state:

> Transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for his direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property.

From the Department's perspective, taxpayer's bar coder, functionally, is used for product identification and verification purposes. Such use is not "essential and integral" to the manufacture of pharmaceuticals.

The drum wash is used by taxpayer to periodically clean production equipment in order to prevent product contamination. Taxpayer advances its exemption argument by relying on IC 6-2.5-5-5.1(b), which provides:

> Transactions involving tangible personal property are exempt from the state gross retail tax if the person acquiring the property acquires it for direct consumption as a material to be consumed in the direct production of other tangible personal property in his business of manufacturing, processing, refining, repairing, mining, agriculture, horticulture, floriculture, or arboriculture.

Taxpayer's drum wash was consumed in the cleaning of production equipment. Taxpayer considers such activity a function of production. The Department, however, finds that taxpayer's cleaning activities are best characterized as a one of maintenance. Taxpayer's cleaning activities are similar to those routine maintenance activities required for all types of production equipment; and such use is not exempt.

As 45 IAC 2.2-5-8(h)(1) instructs:

> Machinery, tools, and equipment used in the normal repair and maintenance of machinery used in the production process which are predominantly used to maintain production machinery are subject to tax.

Consequently, since maintenance is not an exempt activity, the drum wash consumed during the maintenance activity cannot be found exempt. (See 45 IAC 2.2-5-12 (e) and (f).)

FINDING

Taxpayer's protest is denied.

II. Sales/Use Tax — Manufacturing Equipment Used in Clinical Trials and Testing

DISCUSSION

Taxpayer protests the assessment of use tax on equipment used in manufacturing products for clinical trials and process testing.

The equipment at issue is used in two departments – the Chemical Process R&D Department, and the Chemical Pilot Plant Department. Activities of the Chemical Process R&D Department involve the clinical testing of pharmaceutical products. As taxpayer describes "[t]he clinical trials are normally carried out by physicians under contract with the Taxpayer who are supplied the pharmaceutical products to be tested." These trials (tests) are mandatory as government approval is necessary before taxpayer can offer these products for sale to the general public. In addition to testing, the department also manufactures products for sale. According to taxpayer, product sales represented twenty (20) percent of the total production for the department.

The Chemical Pilot Plant Department specializes in "testing and perfecting" taxpayer's production process. Equipment within the department is also utilized to manufacture products as a part of its testing activities. Taxpayer estimates that at least fifteen (15) percent of the products manufactured by the Chemical Pilot Plant Department were subsequently sold to customers.

Audit denied taxpayer use of any of the industrial exemptions as taxpayer was not selling the products that were "manufactured" during these testing processes.

Taxpayer responds by noting that a subsequent sale requirement for manufactured product can not be found in the statutory language upon which the exemption is based. (See IC 6-2.5-5-3(b).) Taxpayer observes, "the production operations required to manufacture the products are functionally equivalent to the production operations required to manufacture products for sale." Same process, same result; the only difference is that in one instance the product is sold, in the other, it is not.

Taxpayer's argument, in a nutshell, proposes that testing, research, and development should be recognized as exempt activities – at least to the extent product is manufactured during the respective processes. Such a broad conclusion, however, does not reflect existing statutory and regulatory language.

Under IC 6-2.5-5-3, machinery, tools, and equipment "directly used in the direct production" of other tangible personal property are exempt from the Indiana gross retail tax. However, to qualify for this exemption, taxpayer must actually be engaged in production. *Indianapolis Fruit v. Indiana Department of State Revenue*, 691 N.E.2d 1379,1383 (Ind.Tax 1998). Therefore, as an initial matter we must determine whether taxpayer's clinical trials and process testing are, in fact, production activities.

The reach of the industrial exemptions coincides with the scope of taxpayer's integrated production process. In defining the scope of this process for manufacturers, the court has drawn boundaries in such a manner to include all the integrated steps necessary to create a finished, marketable product. As the court in *General Motors v. Indiana Department of State Revenue*, 578 N.E.2d 399 (Ind.Tax 1991) stated:

> [A] determination that an integrated production process ends upon the completion of the actual end product marketed (the *most marketable product*) is wholly

> consistent with the legislative purposes of the exemption statutes to encourage industrial growth and to avoid tax pyramiding.

Id. at 405.

Consistent with this statement, and the plain meaning of the word "marketable," the Department finds that for one engaged in manufacturing, a "saleable" item – i.e., an item intended for introduction into the stream of commerce – must be produced.

From taxpayer's description of its Chemical Process R&D and Chemical Pilot Plant activities, these departments are engaged in two different types of manufacturing activities. Taxpayer manufactures products for use in the clinical trials and process testing; and taxpayer manufactures products for subsequent sale.

The Department finds the clinical trial and process testing activities are not a part of taxpayer's integrated pharmaceutical production process. Functionally, such activities are removed from the actual manufacturing processes. Temporally, testing precedes production. Consequently, in the context of taxpayer's business, clinical and process testing are best characterized as research and development activities – i.e., non-exempt activities. (See 45 IAC 2.2-5-12(f).) Furthermore, when taxpayer manufactures products for use in clinical trials, taxpayer has not yet created a "marketable" product. As previously stated, taxpayer cannot offer its products to the general public until testing has been concluded and government approval received.

However, when the aforementioned departments produce saleable products, taxpayer is engaged in an exempt manufacturing activity and should be entitled to the industrial exemptions.

FINDING

Taxpayer's protest is sustained to the extent taxpayer manufactured "marketable" products during its trial and testing processes.

III. Sales/Use Tax — Computer Software

DISCUSSION

Taxpayer protests the imposition of use tax on its purchases of computer software and software licensing agreements.

Taxpayer advances two (2) arguments in support of either exclusion or exemption. First, taxpayer argues that use tax can only be imposed on transactions involving the transfer of tangible personal property. (See IC 6-2.5-3-2(g), IC 6-2.5-3-1(a) and IC 6-2.5-4-1(b).) Taxpayer then summarizes this statutory language by concluding, "use tax statutes [are] unambiguously based on taxpayer's acquisition of tangible personal property." And since computer software and software licensing agreements represent a type of intangible personal

property, "the imposition of Indiana use tax on fees paid for software or software upgrades is erroneous."

Alternately, taxpayer argues that even if computer software were to be considered tangible personal property, taxpayer's computer software and licensing agreements should be exempt because they represent the purchase, or licensing, of *customized* software. Taxpayer refers to *Sales Tax Information Bulletin #8,* which states in part:

> Transactions involving computer software are not subject to Indiana Sales or Use Tax provided the software is in the form of a custom program specifically designed for the purchaser.

Taxpayer believes that some of its software should qualify for exemption as "custom programming." In particular, taxpayer notes that its SAP accounting software represents pre-written software that was extensively modified for its exclusive use. These modifications took eighteen (18) months to complete. Additionally, the original software package was so extensively modified that taxpayer can no longer utilize its vendor's standard software upgrades.

Addressing taxpayer's initial argument, the Department believes the purchase, licensing, or leasing of computer software is tantamount to the purchase, renting, or leasing of tangible personal property – and each represents a taxable event. (See also IC 6-2.5-4-10(a).)

Additionally, even though computer software contains intellectual property, that classification alone is not sufficient to enable the Department to distinguish software from other non-exempt items, or conclude that software should be exempt from sales and use tax. As *Sales Tax Information Bulletin #8* informs:

> Pre-written or canned computer programs are taxable because the intellectual property contained in the canned program is not different than the intellectual property in a videotape or a textbook.

The SAP software represents application software that, according to taxpayer, has been tailored to meet its specific needs. The Department recognizes, however, that software can be tailored in many ways - ranging from the selection of setup, installation, and configuration options to actual modifications of source code.

It is axiomatic that general application software is not re-engineered for each individual licensee or purchaser. At a minimum, there exists some quantum of source code that resides, initially, in every copy of vendor's software. This "core programming" is the equivalent of canned software, and as such, it is taxable.

However, the sale of custom software is not subject to tax in Indiana. Custom software represents a professional service rendered pursuant to 45 IAC 2.2-4-2. (Also see *Sales Tax Information Bulletin #8.*) Modifications and additions to the original source code - changes made specifically for this taxpayer - represent custom programming services; and as such, are

not taxable. In this instance, taxpayer failed to show that the transactions at issue were not unitary in nature. Consequently, the assessment of use tax on the entire amount was proper.

FINDING

Taxpayer's protest is denied.

IV. Sales/Use Tax — Protective Clothing, Safety Supplies, and Equipment Cleanser

DISCUSSION

Taxpayer protests Audit's assessment of use tax on protective clothing, safety supplies, and equipment cleanser.

As taxpayer explains:

> To ensure product integrity, the Taxpayer requires its employees working directly on the production line and in work-in-process testing labs to wear uniforms, hairnets, and beard covers. Employees must also wear shoe covers and safety glasses in clean rooms during the production process. In addition, the Taxpayer uses Dubois drum cleaner to sanitize certain manufacturing equipment. The manufacturing equipment must be cleaned and sanitized after each production run to prevent contamination of the product due to the growth of bacteria during production. The sanitizer is used exclusively to clean production equipment only and is not used for cleaning floors, walls, or non-production equipment.

Taxpayer maintains that under IC 6-2.5-5-3, as property acquired for the direct use in the direct production of other tangible personal property, its protective clothing, safety supplies, and equipment cleanser should be exempt from Indiana sales and use taxes. Taxpayer directs the Department's attention to its own definition of "essential and integral to production" as set out in 45 IAC 2.2-5-8(c)(2):

> (2) The following types of equipment constitute essential and integral parts of the integrated production process and are, therefore, exempt.
>
> * * *
>
> (F) Safety clothing or equipment which is required to allow a worker to participate in the production process without injury or to prevent contamination of the product during production.

Taxpayer argues the aforementioned items were all purchased, and subsequently utilized, to prevent contamination of the product during the manufacturing process.

According to Audit, taxpayer's employees do not change into their company uniforms, or don other protective gear, until they arrive at work. Once at work, a properly attired employee can move, unrestricted, throughout the production facility. Additionally, Audit notes the employees were not required to change uniforms when entering or leaving production areas and facilities during lunch breaks. From these observations, Audit concluded that taxpayer's provision of uniforms did not serve to prevent product contamination. Consequently, the clothing did not qualify for the safety clothing exemption.

The Department agrees with Audit's position. While taxpayer may have supplied employee uniforms to prevent product contamination, the actual use of the uniforms was inconsistent with this intent. Absent evidence to the contrary, the Department concludes the uniforms were not provided for an exempt purpose.

However, such logic does not serve to exclude hairnets, beard covers, and safety glasses from exempt treatment. Even if worn outside production areas and facilities, these items, arguably, are not worn to prevent contamination from outside sources. Therefore, in the context of taxpayer's production processes, the Department finds these items to be exempt safety equipment.

The Dubois drum cleaner was used by taxpayer to sanitize production equipment. In distinguishing "sanitizing" from routine cleaning activities, taxpayer observes, "the sanitizer [Dubois drum cleaner] is used exclusively to clean production equipment only." Nevertheless, from the Department's perspective, whether the items cleaned represent production machinery, office equipment, or building structures, such actions represent cleaning activities. And cleaning is a function of maintenance – a non-exempt, post-production activity. (See 45 IAC 2.2-5-8(h), and 45 IAC 2.2-5-12(e) and (f).)

FINDING

To the extent the hairnets, beard covers, and safety glasses are used by taxpayer's employees while working in production activities, taxpayer's protest is sustained. As to the rest of the items, taxpayer's protest is denied.

V. Sales/Use Tax — Packaging Equipment and Supplies

DISCUSSION

Taxpayer protests the assessment of use tax on supplies and equipment used in its packaging of pharmaceutical products.

Within taxpayer's Packaging Department, there exist several types of packaging lines – bottle lines, blister pack lines, a hand fill line, and a Jone Cartoner line. Each line performs the packaging function using its own methodology and specialized equipment. Audit proposed assessments on the equipment used in these activities.

The Indiana Supreme Court has interpreted IC 6-2.5-5-3, one of the industrial exemptions, as exempting equipment found to be essential and integral to taxpayer's integrated production process. *Indiana Department of State Revenue v. Cave Stone, Inc.*, 457 N.E.2d 520 (Ind. 1983). The scope of this integrated production process for pharmaceutical manufacturers is discussed in 45 IAC 2.2-5-8(d)(1):

> The production of pharmaceutical items is accomplished by a process which begins with weighing and measuring out appropriate ingredients, continues with combining and otherwise treating the ingredients, and ends with packaging the items. Equipment used to transport raw materials to the manufacturing plant is employed prior to the first operation or activity constituting part of the integrated production process and is taxable. Weighing and measuring equipment and all equipment used as an essential and integral part of the subsequent manufacturing steps, through packaging, qualify for exemption. Equipment which loads packaged products from the packaging step of production into storage, or from storage into delivery vehicles, is subject to tax. (Emphasis added.)

Absent, however, from taxpayer's argument is language describing the context of taxpayer's packaging activities. Consequently, taxpayer has not met its burden of proof.

FINDING

Taxpayer's protest is denied.

PE/BK/MR –992206